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THE CAUSES AND EFFECTS OF THE LEHMAN

BROTHERS BANKRUPTCY

Monday, October 6, 2008

House of Representatives,

Committee on Oversight and

Government Reform,

Washington, D.C.

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Committee Hearings

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The committee met, pursuant to call, at 10:09 a.m., in Room 2154, Rayburn House Office Building, Hon. Henry A. Waxman [chairman of the committee] presiding.

Present: Representatives Waxman, Maloney, Cummings, Kucinich, Tierney, Watson, Higgins, Yarmuth, Braley, Norton, McCollum, Cooper, Van Hollen, Sarbanes, Welch, Davis of Virginia, Shays, Mica and Turner.

Staff Present: Kristin Amerling, General Counsel; Caren Auchman, Press Assistant; Phil Barnett, Staff Director and Chief Counsel; Jen Berenholz, Deputy Clerk; Alison Cassady, Professional Staff Member; Brian Cohen, Senior Investigator

and Policy Advisor; Zhongrui "JR" Deng, Chief Information Officer; Greg Dotson, Chief Environmental Counsel; Miriam Edelman, Special Assistant; Earley Green, Chief Clerk; David Leviss, Senior Investigative Counsel; Karen Lightfoot, Communications Director and Senior Policy Advisor; Jennifer Owens, Special Assistant; Leneal Scott, Information Systems Manager; Roger Sherman, Deputy Chief Counsel; Mitch Smiley, Special Assistant; Lawrence Halloran, Minority Staff Director; Jennifer Safavian, Minority Chief Counsel for Oversight and Investigations; A. Brooke Bennett, Minority Counsel; Brien Beattie, Minority Professional Staff Member; Molly Boyl, Minority Professional Staff Member; Larry Brady, Minority Senior Investigator and Policy Advisor; Alex Cooper, Minority Professional Staff Member; John Cuaderes, Minority Senior Investigator and Policy Advisor; Adam Fromm, Minority Professional Staff Member; Todd Greenwood, Minority Professional Staff Member; Patrick Lyden, Minority Parliamentarian and Member Services Coordinator; Brian McNicoll, Minority Communications Director; Nick Palarino, Minority Senior Investigator and Policy Advisor; and Mark Marin, Minority Professional Staff Member.

Chairman WAXMAN. The meeting of the committee will please come to order.

On Friday, Congress passed a $700 billion rescue package for Wall Street. This was something no Member wanted to do. If Wall Street had been less reckless, or thorough regulators had been more tentative, the financial crisis could have been prevented. But we voted for the $700 billion rescue because the consequences of doing nothing were even worse.

The excesses on Wall Street have caused a credit freeze that threatened our entire economy. The $700 billion rescue plan is a life-support measure. It may keep our economy from collapsing, but it won't make it healthy again. To restore our economy to health, two steps are necessary. First we must identify what went wrong, then we must enact real reforms for our financial markets.

Over the next 3 weeks, we will start this process in this committee. We will be holding a series of five hearings on the financial meltdown on Wall Street. We'll examine how the system broke down, what could have been done to prevent it, and what lessons we need to learn so this won't happen again.

Today's hearing examines the collapse of Lehman Brothers, which, on September 15th, filed for bankruptcy, the largest bankruptcy filing in American history. Before the Lehman Brothers bankruptcy, Treasury Secretary Paulson and

Federal Reserve Chairman Bernanke told us our financial system could handle the collapse of Lehman. It now appears they were wrong. The repercussions of this collapse have reverberated across our economy. Many experts think Lehman's fall triggered the credit freeze that is choking our economy, and that made the $700 billion rescue necessary.

Lehman's collapse caused a big money market fund to break the buck, which caused investors to flee to Treasury bills and dried up a key source of short-term commercial paper. It also spread fear throughout the credit markets, driving up the costs of borrowing.

Over the weekend we received the testimony, the written testimony, of Richard Fuld, the CEO of Lehman Brothers. Mr. Fuld takes no responsibility for the collapse of Lehman. Instead he cites a, quote, litany of destabilizing factors, end quote, and says, quote, in the end, despite all our effort, we were overwhelmed, end quote.

In preparation for today's hearing, the committee received thousands of pages of internal documents from Lehman Brothers. Like Mr. Fuld's testimony, these documents portray a company in which there was no accountability for failure. In one e-mail exchange from early June, some executives from Lehman's money management subsidiary Neuberger Berman made this recommendation: Top management should forego bonuses this year. This would serve a dual purpose. Firstly, it

would represent a significant expense reduction; secondly, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance.

The e-mail was sent to Lehman's executive committee. One of its members is George H.--George H. Walker, President Bush's cousin, who is responsible for overseeing Neuberger Berman. And here is what he wrote the executive committee. Quote, sorry, team. I'm not sure what is in the water at 605 Third Avenue today. I'm embarrassed, and I apologize, end quote.

Mr. Fuld also mocked the Neuberger suggestion that top management should accept responsibility by giving up their bonuses. His response was, quote, don't worry, they are only people who think about their own pockets, end quote.

Another remarkable document is a request submitted to the compensation committee of the board on September 11th, 4 days before Lehman filed for bankruptcy. It recommends that the board give three departing executives over $20 million in, quote, special payments. In other words, even as Mr. Fuld was pleading with Secretary Paulson for a full rescue, Lehman continued to squander millions on executive compensation.

Other documents obtained by the committee undermine Mr. Fuld's contention that Lehman was overwhelmed by forces

outside of its control. One internal analysis reveals that Lehman saw warning signs, but did not move early/fast enough, and lacked discipline about capital allocation.

In 2004, the Securities and Exchange Commission relaxed a rule limiting the amount of leverage that Lehman and other investment banks could use. As this chart--Lehman chart shows--and if we could have that posted, I would appreciate it--that proved to be a temptation the firm could not resist. So in 2004, the SEC allowed greater leverage, and Lehman and other banks couldn't resist that and took on more leverage.

At first Lehman's bets paid out. As Mr. Fuld's testimony recounts, Lehman achieved 4 consecutive years of record-breaking financial results between 2004 and 2007. These were lucrative years for Lehman's executives and Mr. Fuld. Lehman paid out over $16 billion in bonuses. And we do have the chart now on the screen. Lehman paid out over $16 billion in bonuses. Mr. Fuld himself received over $40 million in cash bonuses. His total compensation during these 4 years exceeded $260 million.

But while Mr. Fuld and other Lehman executives were getting rich, they were steering Lehman Brothers and our economy toward a precipice. Leverage is a double-edged sword. When it works as it did in 2004 to 2007, it magnifies investment gains. But when asset failures decline as the subprime market did, leverage rapidly consumes a company's

capital and jeopardizes its survival.

Mr. Fuld's actions during this crisis were questionable. In a January 2008 presentation, he and the Lehman board were warned that the company's liquidity can disappear quite fast. Yet despite this warning, Mr. Fuld depleted Lehman's capital reserves by over $10 billion through year-end bonuses, and stock buybacks and dividend payments. In one document a senior executive tells Mr. Fuld that if the company can secure $5 billion in financing from Korea, quote, I like the idea of aggressively going into the market and spending 2- of the 5- in buying back lots of stock and hurting Einhorn bad. This action might have inflicted short-term losses on a short seller Lehman despised, but it would have burned through even more capital. Mr. Fuld's response: I agree with all of it.

What is fundamentally unfair about the collapse of Lehman is its impact on the economy and taxpayers. Mr. Fuld will do fine. He can walk away from Lehman a wealthy man who earned over $500 million, but taxpayers are left with a $700 billion bill to rescue Wall Street and an economy in crisis.

Risk taking has an important role in our economy, but Federal regulators are supposed to ensure that these risks don't become so large that they can imperil our entire economy. They failed miserably. The regulators had a blind faith in the market and a belief that what was good for Mr. Fuld and other executives on Wall Street was good for

America, and we are now all paying a terrible price.

We can't undo the damage of the past 8 years. That is why I reluctantly voted for the $700 billion rescue plan. But we can start the process of holding those responsible to public account and identifying the reforms we need for the future. These are the goals of today's hearing and the other hearings we will be holding this month.

[Prepared statement of Mr. Waxman follows:]

******** INSERT 1-1 ********

Chairman WAXMAN. I would now like to recognize Mr. Davis for his opening statement.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman. We have Members on this side who would like to make opening statements. What is the position to be today?

Chairman WAXMAN. The rules of the committee provide that the Chairman and the Ranking Member may make opening statements. We have many Members here. We have many witnesses that will also be here to--also here to make their presentations. So the Chair will stick by the rules. Opening statements only by the Chairman and the Ranking Member.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman.

Mr. SHAYS. I'd just like to ask unanimous consent that Members be allowed to make an opening statement. This is a hugely important hearing. It is the beginning of five hearings, and frankly there is some--

Chairman WAXMAN. There is objection to that. The rules don't provide for it, and the committee will not give unanimous consent for it.

Mr. SHAYS. I haven't finished my motion.

Chairman WAXMAN. The Chair has recognized Mr. Davis for an opening statement.

Do you wish to make a motion, Mr. Shays?

Mr. SHAYS. I wish to make a unanimous consent motion

that we be allowed to--because I believe there is a cover-up going on, and I'd like to make a statement.

Chairman WAXMAN. We'll follow the rules. Mr. Davis is recognized for his opening statement.

Mr. DAVIS OF VIRGINIA. Thank you, Mr. Chairman, for convening a series of hearings to examine the many complex and interlocking causes and effects of the economic paralysis gripping our Nation and most of the industrialized world. Today, tomorrow and in the coming weeks we'll ask some tough questions about the role of investment firms like Lehman Brothers Holding, insurers like AIG, hedge funds, credit-rating agencies, regulators and Congress in feeding the boom that has now gone so painfully bust.

I particularly appreciate you calling Lehman Brothers up today before us. Mr. Fuld, a very active contributor to Democratic causes, along with Mr. Janulis, Mr. Demura, Mr. Collerton and others, have been bypassed by other committees, and I appreciate your having the courage to call him up here today.

The scope of these hearings effectively rebuts the simplistic premise peddled by some that laissez-faire Republicanism and mindless deregulations alone caused the collapse of global capital markets. That's the political cartoon version of a very complicated life-and-death reality. Partisan fingerpointing adds nothing to serious oversight of

the intricate web of individuals, institutions, market incentives and cyclical trends that have brought us to the brink of economic abyss.

For more than a decade, all the Wall Street and Washington players engaged in an increasingly elaborate game of high-takes musical chairs driven by the mesmerizing siren song of perpetually rising housing costs. But when the music stopped, as it always does, many formally upstanding financial giants found themselves without a safe or a sound place to sit. Suddenly the phrase "too big to fail" measured only the limits of our foresight, not the size of the all too foreseeable failure.

So today we start with the case of Lehman Brothers, a venerable investment house that sank into insolvency while others were being thrown Federal lifelines. One lesson from Lehman's demise: Words matter. Rumors and speculative leaks fed the panic and accelerated a flight of confidence in capital from that company.

Words matter here as well. Look at the TV monitors. As we watch them, the markets are watching us. In this volatile environment, unsupported allegations, irresponsible disclosures can inflame fears and trigger market stampedes. As these hearings proceed, we should watch the pulse of Wall Street and choose our words with great care.

But it must be said the driving factor in the loss of

value and confidence in Lehman was the financial undertow created by falling home prices and resulting losses on mortgage-backed assets of all kinds. And central to that crisis in the $12 trillion mortgage securities market were imprudent policies and cozy practices of the two government-sponsored housing finance giants, Fannie Mae and Freddie Mac. We have asked that former Fannie Mae CEO Franklin Raines be invited to testify at a future hearing because that company's failure offers Congress lessons that we dare not overlook. You can't have a complete analysis without looking at Freddie and Fannie.

Many in Congress did turn a blind eye to clear warnings of impending danger sounded as early as 1998. They missed golden opportunities to treat localized problems before they metastasized throughout the economic system. Out of well-intentioned zeal to promote homeownership, Members from both parties and both Chambers not only tolerated, but encouraged the steady erosion of mortgage-lending standards. When an alarm sounded, Fannie and Freddie, holding low-income borrowers as political hostages, mobilized armies of expensive lobbyists to block calls for greater accountability and transparency. Using lobbying fees and campaign contributions, the mortgage giants bought their way around attempts by Senate and House Banking Committees to pierce their profitable pyramid scheme. The Clinton administration

was rebuffed by a Republican Congress, and this administration had no more success with the Democratic Congress in advancing needed reforms.

This committee cannot ignore that sad history in our inquiries into the causes and effects of the current economic crisis. But now that the $700 billion economic rescue bill has been enacted, the debate is no longer whether the Federal Government should intervene in the credit markets, but how that intervention should be managed to stabilize capital flows and protect taxpayers. Although it comes too late to help Lehman Brothers, the so-called bailout program will have to make wrenching choices, picking winners and losers from a shattered and fragile economic landscape.

These hearings should help mark the land mines and potholes on the path to a restoration of trust and economic vitality. Trust. There is a moral dimension to economics we don't often want to confront. Economics is not an objective discipline, but a political art grounded in certain assumptions about human nature and civilized behavior. As the process of deleveraging unfolds, breaking the economy's delusional addiction to debt beyond our reasonable means to repay, the goal has to be a restoration of the moral bond between labor and capital. We need to restore faith in production, savings and investment over consumption, spending and speculation. Our witnesses today can help us do that.

We appreciate their being there.

Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you very much, Mr. Davis.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. DAVIS OF VIRGINIA. I also ask unanimous consent for our staff analysis to be included in the hearing record.

Chairman WAXMAN. Without objection, that will be the order.

[The information follows:]

******** COMMITTEE INSERT ********

Mr. SHAYS. Mr. Chairman, a parliamentary inquiry.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. SHAYS. Thank you.

In my request for permission to have the Members give an opening statement, I'd like the Chair to please cite the provision of committee rules or House rules on which he relies for the proposition that only the Chair and Ranking Member may make opening statements.

Chairman WAXMAN. The rule provides--in general the House and committee rules do not address the common practice of opening statements by Members at hearings and meetings. The only exception is House Rule 11, clause (2)(k)(1), which provides that the Chairman at a hearing shall announce in an opening statement the subject of an investigation. Because there is no limitation on opening statements in the rule, every member of the committee has the right to--has a right to seek recognition, but that as a matter of House rules, the refusal of the Chair to recognize a Member for an opening statement is not appealable. As a practical matter, controversy relating to handling of opening statements are normally dealt with by consensus within the committee. The committee has always operated on the basis of the Chairman and the Ranking Member, and that is the way we'll continue to do so.

Mr. MICA. Mr. Chairman, parliamentary inquiry.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. Mr. Chairman, I have been on the committee with you for 16 years. I had the opportunity to chair two subcommittees.

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. I am stating, but I have to have a preface for my--

Chairman WAXMAN. The gentleman will state his parliamentary inquiry.

Mr. MICA. During the entire tenure of my chairmanship, I afforded as a courtesy every Member on either side in every hearing the opportunity for an opening statement. Now, it may not be in the rules, Mr. Chairman, and you have the ability to now reject my request for an opening statement.

Chairman WAXMAN. The Chairman--

Mr. MICA. I would ask you in fairness an opportunity for all sides to be heard on this important hearing, the opportunity--I'm asking you honor the ability of my--of the rules just stated to allow me to present a 5-minute opening statement.

Chairman WAXMAN. Well, the Chairman notes the presence of many, many Members. To allow you to make an opening

statement and not others would be unfair. The rules do not provide for all Members to have the right to an opening statement. There are occasions when Members have been given that opportunity, especially when it is a small subcommittee, as you chaired. But we have too many Members here and too many witnesses to be heard. So the Chair did not hear a parliamentary inquiry, but a personal appeal, which the Chair denies.

We have with us the following witnesses: Nell Minow, chairman of the board and editor of The Corporate Library; Gregory W. Smith, general counsel, Colorado Public Employees' Retirement Association; Robert F. Wescott, Ph.D., president of Keybridge Research LLC; Luigi Zingales, Ph.D., professor at the University of Chicago Graduate School of Business; and Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute.

And it is the policy of this committee that all witnesses that testify before us do so under oath, so I'd like to ask each of you to please stand and raise your right hand.

[Witnesses sworn.]

Chairman WAXMAN. The record will indicate that each of the witnesses answered in the affirmative.

Your prepared statements will be in the record in full. We would like to ask each of you to be mindful that we have a

clock that will indicate when 5 minutes is up. We'd like you to stay as close to the 5 minutes as possible. There will be a green light for 4 minutes, a yellow light for the last minute. And then when it turns red, the 5 minutes has expired.

Dr. Zingales, am I pronouncing your name correctly? Okay. There is a button on the base of your mic. Be sure it is in, and we'd like to hear from you first.

STATEMENTS OF LUIGI ZINGALES, PROFESSOR OF FINANCE, UNIVERSITY OF CHICAGO; ROBERT F. WESCOTT, PRESIDENT, KEYBRIDGE RESEARCH LLC; NELL MINOW, CHAIRMAN OF THE BOARD AND EDITOR, THE CORPORATE LIBRARY; GREGORY W. SMITH, GENERAL COUNSEL, COLORADO PUBLIC EMPLOYEES' RETIREMENT ASSOCIATION; AND PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

STATEMENT OF LUIGI ZINGALES

Mr. ZINGALES. Okay. Thank you. Chairman Waxman, Ranking Minority Davis, members of the committee, thank you for inviting me.

The demise of Lehman Brothers is the result of a very aggressive leverage policy in the context of a major financial crisis. The roots of this crisis have to be found in bad regulation, lack of transparency, and market complacency brought about by several years of positive returns.

A prolonged period of real estate price increases and the boom of securitization relaxed lending standards. The quality of these mortgages should have been checked by the capital market that bought them, but several problems made

this monitoring less than perfect. First, these mortgages were priced based on historical records, which did not factor in the probability of a significant drop in real estate prices at the national level. Nor did they factor the effect of the changes in the lending standards on the probability of default.

Second, the massive amount of issuance by a limited number of players, which Lehman was one, changed the fundamental nature of the relationship between credit-rating agencies and the investment banks issuing the securities. As a result, instead of submitting an issue to the rating agency's judgment, investment banks shopped around for the best ratings and even received handbooks on how to produce the riskiest security that qualified for a AAA rating.

The market was not completely fooled by this process. AAA-rated asset-backed securities had a higher yield than corporate AAA, a clear indication of the higher risk.

Unfortunately, regulatory constraints created inflated demand for these products. Fannie Mae and Freddie were allowed, even induced, to invest their funds in these securities, creating an easy arbitrage. They issued AAA-rated debt and invested in higher-yield AAA-rated debt.

Another source of captive demand were money market funds. Being required to hold only highly rated securities, money market funds loved these instruments and satisfied the

regulatory requirements and boosted their yields.

Most managers of these firms were aware of the gamble they were taking, but could not resist taking it under an intense competition for yield-hungry customers. These managers were also hoping that if a shock occurred, all their competitors would face the same problem, thereby reducing the reputational costs and possibly triggering a government support. The September 19 decision to insure all money market funds validated this gamble, forever destroying money market managers' incentives to be careful in regard to the risks they take.

The pooling of mortgages, while beneficial for diversification purposes, became a curse as the downturn worsened. The lack of transparency in the issuing process made it difficult to determine who owned what. Furthermore, the complexity of these repackaged mortgages is such that small differences in the assumed rate of default can cause the value of some tranches to fluctuate from 50 cents on the dollar to zero. Lacking information on the quality and hence the value of banks' assets, the market grew reluctant to lend to them for fear of losing out in case of default.

In the case of Lehman and other investment banks, this problem was aggravated by two factors, the extremely high level of leverage and the strong reliance on short-term debt financing. While commercial banks cannot leverage their

equity more than 15 to 1, Lehman had a leverage of more than 30 to 1. With this leverage, a mere 3.3 percent drop in the value of assets wipes out the entire value of equity and makes the company insolvent.

In turn, the instability created by a leverage problem was exacerbated by Lehman's large use of short-term debt. Reliance on short-term debt increases the risk of runs similar to the ones bank face when they are rumored to be insolvent. The Lehman CEO will likely tell you that his company was solvent, and it was brought down by a run. This is a distinct possibility. The problem is that nobody knows for sure. When Lehman went down, it had $26 billion in book equity, but the doubts about the value of its assets combined with the high degree of leverage created a huge uncertainty about the true value of this equity. It could have been worth $40 billion or negative 20-.

It is important to note that Lehman did not find itself in that situation by accident. It was the unlucky draw of a consciously made gamble.

Lehman Brothers' bankruptcy forced the market to assess risk. As after a major flood, people start to buy flood insurance. After the demise of Lehman, the market started to worry about several risks previously overlooked. This risk reassessment is crucial to support a market discipline. The downside is that it can degenerate into a panic.

Chairman WAXMAN. Thank you very much, Dr. Zingales.

[Prepared statement of Mr. Zingales follows:]

******** INSERT 1-2 ********

Chairman WAXMAN. Dr. Wescott.

STATEMENT OF ROBERT F. WESCOTT

Mr. WESCOTT. Chairman Waxman and members of the committee, thank you for inviting me to testify today about the financial meltdown on Wall Street. I'll focus my comments on the main causes of the financial crisis. During questions, I'm also happy to discuss its economic effects and also the lessons we might draw about it for public policy. I'll give you an economist's perspective, drawing on my experiences in forecasting the U.S. economy, in participating in the national economic policymaking process at the National Economic Council of the White House, and in researching global and economic financial risks.

In my opinion, there were three main contributors to the financial meltdown. The first was an environment of easy credit that existed in the first half of this decade. We simply left the monetary floodgates open too far and too long in the period 2002 to 2005. During this period, mortgage rates got as low as 2-1/2 percent, and families got an inflated sense of their capacity to afford housing. This cheap credit quickly got capitalized in housing prices, and housing prices doubled and even tripled in some neighborhoods

in the span of just a few years. This caused a housing frenzy, and many Americans developed unrealistic expectations and assumed that housing prices could only go up.

The second key development was mortgage securitization, the bundling of pools of mortgages, their underwriting and their sale to institutional investors. This increased liquidity and made mortgage money cheaper than--because we could tap the savings of global savers. On the downside, however, it also meant that the mortgage originator was no longer going to hold the mortgage to maturity. So it did not have a strong incentive to perform due diligence on the loan.

In this environment of easy credit, there was lots of competition. Lenders began loosening standards to win business and increase market share. This led to an easing of down payment requirements and a proliferation of unconventional mortgages, including teaser rate mortgages, no doc mortgages, option payment mortgages and so on. Eventually homebuyers were receiving 100 percent loan-to-value mortgages, a very dangerous predictor of default risk.

The third key development was an increase in leverage by investment banks, as has just been stated. Whereas a traditional bank might have a leverage ratio of, say, four, meaning that the value of its obligations was four times the value of its shareholders' equity, investment banks increased

their leverage ratios to 30 or 35 times in the past few years. Such high leverage ratios meant that there was much less cushion in hard times.

Well, how did these ingredients mix? As long as house prices kept appreciating steadily, all players in the system had a strong incentive to keep going and keep doing what they were doing. It was good for existing homeowners because they had asset appreciation, and they had great opportunities for extracting equity out of their houses through cash-out refinancings and home equity loans. Basically families started using their houses as ATM machines. It was good for new homebuyers, including speculators, because they saw almost immediate price gains. It was good for mortgage brokers. They earned hefty origination fees. It was good for rating agencies. They had great business. And it was good for investment banks because they were earning large securitization fees.

The system boomed this way for many years. The problem came when the U.S. housing sector simply reached saturation. By early 2006, almost every American who wanted a home was in one. The Fed started raising interest rates to fight inflation, and suddenly housing prices leveled off and then began to fall. Some borrowers, especially subprime borrowers, began to miss their monthly mortgage payments, and the value of subprime mortgage portfolios began to decline.

Now, because of the high leverage in the investment banks, many simply did not have the cushion to fall back on.

The problems were compounded by a rapidly weakening U.S. economy. As the housing sector weakened, overall U.S. economic growth was cut roughly in half, and the drying up of home equity loans and cash-out refinancings hurt consumption. By early 2008, 10 percent of all U.S. households were underwater with their mortgages, meaning that they owed more on their house than their house was worth. These events set the stage for the financial and liquidity crisis we have today.

The cause of Lehman Brothers--basically the collapse of Lehman Brothers in September was effectively the pinprick that burst the bubble. Mr. Chairman, the collapse of Lehman shook the market's financial confidence and set off the liquidity crisis that has thrown sand into the gears of the U.S. economic engine.

What lessons should we draw? Any time the price of a major asset class or commodity increases 200 percent or 300 percent in a matter of just a few weeks--in a matter of just a few years, whether it is home prices, timber, Dutch tulips, oil, gold, technology, stocks, we need to ask questions. Prudent regulators need--needed to ask whether the system they regulate could tolerate a rapid return of asset prices to the historical trading range, and private executives

running investment banks who wanted to maximize their shareholders' value in the long term needed to ask whether their business model could tolerate a rapid return of asset prices to their historical range.

Thank you.

Chairman WAXMAN. Thank you very much, Dr. Wescott.

[Prepared statement of Mr. Wescott follows:]

******** INSERT 1-3 ********

Chairman WAXMAN. Ms. Minow.

STATEMENT OF NELL MINOW

Ms. MINOW. Thank you very much, Mr. Chairman and Members. It is an honor to participate in this hearing. I appreciate it very much. And I would give anything if what I wasn't here to say was, "I told you so."

I have testified before this committee before, and what I said then was that there is no more reliable indicator of investment--litigation and liability risk than excessive CEO compensation. CEO compensation is not just the symptom, it is actually a cause. It pours gasoline on the fire.

With that in mind, I'd like to tell you what our ratings have been. My company, The Corporate Library, rates boards of directors, and in part we look at decisions they make, like CEO pay. We have given this company a C or a D since we started rating them, with one very brief exception of a couple of months where we gave them a B.

Here is a quote from our analyst's note on the company: Although the CEO's 2007 salary is well below the median for companies of similar size, his nonequity incentive compensation of $4,250,000 exceeded the 85th percentile. While typical target bonus is two times base salary, Mr.

Fuld's was more than five times his base salary. Additionally, his total annual compensation of $71,924,178 ranks in the top 3 percent for similarly sized companies.

As I've mentioned before, this is the problem. When we pay people based on the volume of business rather than the quality of business, eventually it is like a game of musical chairs. And when the music stops, the people that don't have a place to sit are the investors.

Pay that is out of alignment is one of the causes of poor performance, but it is also an important symptom of an ineffective board. Let's talk about this board for just a minute. They had a finance and risk management committee. I think that my economist colleagues here would agree, and my investor colleague, that the--in a company like this, the finance and risk management committee is a very important committee, and yet it only met twice in 2007 and twice in 2006. The crystal-clear explanations of Dr. Zingales and Dr. Wescott were--as brilliant as they are, were not unknown at the time. These were things that the risk committee should have been looking at.

An additional indicator is the meaningful stock ownership by the board. It is a public statement of their confidence in a company and a powerful reminder and motivator for them as they deliberate issues like executive compensation and risk management. With the exception of the

CEO who sold the significant percentage of his stock, and the lead director, and the 23-year veteran on the committee, given their tenure, these directors did not put their money where their mouths were.

I'm really horrified by the effort by Mr. Fuld and other executives in these failing companies to absolve themselves of blame. It infuriates me when they talk about how efficient the markets are except when they are not efficient. All of a sudden, it is not their fault anymore. These are people who fight for deregulation, and now they're blaming the regulators.

They talk about a litany of destabilizing factors. Let me tell you that the most important destabilizing factor was: an inefficient and ineffective board of directors and bad judgment by the executives. People make mistakes, but what we like to see is people accepting responsibility and participating in mitigating damages and preventing the recurrence. It is indispensable for the credibility of our capital markets to align the interests of executives with the investors, and we'll have an enormously increased cost of capital if we do not make that clear throughout the world.

What we had was an executive compensation system that created an incentive for imagining derivative securities that exploited regulatory and accounting loopholes. I had a presentation at the Public Company Accounting Oversight Board

where they told us that Paul Volker said he didn't understand these derivatives. I hereby propose the Paul Volker rule, that if he doesn't understand it, we shouldn't put it out on the markets. Even if executives are overwhelmed by forces beyond their control, I believe you've heard this expression before, that is why we pay them the big bucks.

Thank you.

Chairman WAXMAN. Thank you. No demonstrations. Thank you, Ms. Minow.

[Prepared statement of Ms. Minow follows:]

******** INSERT 1-4 ********

Chairman WAXMAN. Mr. Smith.

STATEMENT OF GREGORY W. SMITH

Mr. SMITH. Thank you, Mr. Chairman. Thank you, Members, for having me here today to express the perceptions and perspective of a major institutional investor. One of the things that I want to address--you certainly heard some good diagnosis and comments from people much more qualified than I to assess why this has happened. I'd like to put a little bit of a face to this.

We hear a lot in the media about the savior of Wall Street, and we hear a lot about major institutions and--throughout the country, Wall Street being saved. We think this is about every working American in the United States. It is about people that I work for every day. I work for a pension fund that represents 420,000 current and former public employees, public servants in the State of Colorado. We represent every State trooper, every teacher in the State of Colorado, every State employee, every judge and over 400 employers, including all of our local divisions of government. These--the individuals are the ones that are being impacted in this crisis. It is the individuals who are having to face the questions of whether their college fund

for their children is going to still be around when this is over. It is these individuals who are wondering how long is it until retirement now, how long do I have to go before I can recover from what Wall Street has done to me this time.

And what it really has boiled down to is a complete collapse in investor confidence. And it is a complete collapse in investor confidence because they no longer believe in management, they no longer believe in the numbers, and they no longer believe in the regulatory framework for good reason.

We don't claim to know, I certainly don't claim to be able to articulate, why this happened, and I certainly would not predict what the result of the blame game is going to be. There is certainly going to be one, and the lawyers are going to spend a lot of time on it. What we would like to urge you to consider is what the future needs to hold to regain confidence, and what it needs to consist of is an opportunity for shareholders to be heard in a meaningful way at a meaningful time in the process of running corporate America. We need access to the proxy. We need to be able to hold the directors accountable. If they're not doing a good job, we need to be able to get them out of the boardroom and get somebody else in that will represent shareholders.

We need a regulatory framework that is aligned with the shareholder, not with corporate America, but with the

shareholders, and a regulatory framework that is prepared to hold people accountable that breach their duty to the shareholder.

That's where we need to go. We need to have say on pay, and we need to be able to regain confidence that this market is about the shareholder, it is about mom and pop, it is about small businesses, and it is about the individuals that I represent all over this country.

One of the things that doesn't get talked about very much and that is really impacting the people that I work with is the credit crisis and the freezing of their accounts. People who have been the most conservative investors and who have thought, well, I don't want to get involved in these speculative things, I'm going to put my money in a money market, I'm going to fall behind inflation, I don't really worry about inflation, I want to make sure I have my money, those people don't have their money now.

We manage our cash through those types of accounts. There were times last week and 2 weeks ago that our money was on the brink of being frozen. People in this country are not going to be able to make payroll. Small businesses are not going to make payroll because they are not going to be able to access their cash.

These are the problems that we believe are yet to come. Some of them you've begun to see. But there is many more to

come, and it is the working people of America that are suffering this crisis. It is not about Wall Street, it is about investor confidence, And that is what needs to be restored.

Thank you.

Chairman WAXMAN. Thank you very much, Mr. Smith.

[Prepared statement of Mr. Smith follows:]

******** INSERT 1-5 ********

Chairman WAXMAN. Mr. Wallison.

STATEMENT OF PETER J. WALLISON

Mr. WALLISON. Thank you, Mr. Chairman and members of this committee. I'm really pleased to have this opportunity to address the question of regulation and its role in the current financial crisis.

There are cases where regulation is necessary and cases where it is harmful. It was necessary in the case of Fannie Mae and Freddie Mac. These two companies were seen in the market as backed by the Federal Government. As a result, investors did not worry about the risks of lending to them since Uncle Sam would bail them out if the companies got into financial trouble. Investors have been proved right. In cases where investors see themselves as bearing no risks lending to a private, shareholder-owned company, strong regulation is essential. That is the only way that government can protect itself against loss. Yet Congress resisted--

Chairman WAXMAN. Mr. Wallison, could you pull the mic a little closer? Some Members are having--

Mr. WALLISON. Oh, I'm sorry.

Yet Congress resisted reforming regulation of Fannie Mae

and Freddie Freddie until it was too late. And even then the reform legislation wouldn't have been passed unless it had been attached to a housing bill that Congress wanted to adopt before going home for the August recess.

The failure by Congress had serious consequences. An article in yesterday's New York Times makes clear that reckless buying of junk loans by Fannie Mae and Freddie Mac bears a large part of the responsibility for the financial crisis we are now in. Voters, justifiably angry about the $700 billion rescue plan just adopted by Congress, should recognize who is responsible and act accordingly.

Incidentally, since some issues of compensation have come up, I ought to mention that Fannie was very generous in its own compensation. Franklin Raines, who was its Chairman for several years, 4 or 5, made $90 million during the time he was there, and there was little outrage expressed in Congress at that time.

Bad or weak regulation is often worse than no regulation at all. Another article in the New York Times on Friday of last week recounted the SEC's failure to devote sufficient resources to the regulation of the major investment banking firms that have now all collapsed, been taken over, sold themselves to big banks or sought shelter under the Federal Reserve's wings as financial holding companies. According to the article, the SEC assigned a pitifully small staff to

regulating these huge investment banks, and as a result they took imprudent financial risks that ultimately led to their losses.

A chart accompanying the article shows that these institutions took increasing risks every year from the time they entered the SEC's supervisory regime. This is important. It demonstrates the effect of regulation in creating moral hazard. Immediately after the SEC took over the supervision of their safety and soundness, the market discipline to which they had previously been subject began to relax. Investors thought the SEC was minding the store, but it wasn't. That is why weak regulation can be worse than none.

Regulation itself is no panacea. Even strong regulation may not be effective. Regulation of commercial banks in the United States is a case of strong regulation failing. Congress imposed a strong regulatory regime on commercial banks when it adopted FDICIA in 1991. Still, even though IndyMac, WAMU, Wachovia and dozens of smaller commercial banks were regulated by one or another agency of the Federal Government under strict FDICIA requirements, they all failed or had to be taken over just like the weakly regulated investment banks.

Calling for more regulation as a solution to the financial crisis is, therefore, somewhat simplistic.

Regulation's track record is ambiguous. There is no question that it is the only protection we have when the government is exposed to risks created by companies it backs, like commercial banks, which have deposits insured by the FDIC, and like Fannie Mae and Freddie Mac, which were seen as backed by the Federal Government without any limit.

But the regulation of the investment banks by the SEC was a mistake. They were not seen as backed by the government in any way until the SEC was given authority to supervise their safety and soundness. Then their risk-taking took off. If they had been left free of government oversight, they would not, in my view, have been able to borrow the funds that created their extraordinary leverage.

If our solution to today's crisis is to regulate hedge funds, private equity funds, finance companies, institutional lenders, pension funds, leasing companies and insurance companies and anyone else who participates in the capital markets without any government backing, we will simply be assuring ourselves of many more financial crises in the future.

Many thanks, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Wallison.

[Prepared statement of Mr. Wallison follows:]

******** INSERT 1-6 ********

Chairman WAXMAN. I want to thank all of the members of the panel for your presentation. We'll now recognize Members to ask questions for a 5-minute period. We'll start with Mrs. Maloney.

Mrs. MALONEY. Thank you, Mr. Chairman and Ranking Member Davis and all of the panelists.

We are facing what has been called the most serious financial crisis since the 1930s. And the potential cost to taxpayer is staggering: $29 billion to J.P. Morgan to buy Bear Stearns; $85 billion to AIG; $200 billion to Fannie and Freddie; $700 billion rescue package; $300 billion to the Fed window opening it up to investment banks; $50 billion to stabilize the money market funds. A staggering $1.7 billion potential cost to taxpayers.

Now, Professor Zingales, you seem to believe that this may have been caused by the staggering leverage that was put in these firms, but others see it as the deregulation that has taken place in Congress over the past decade. In 1990, Congress passed the Financial Stabilization Act, which took away the protections of the Glass-Steagall Act that had served and protected our economy for 80 years. This allowed the banking a safety and soundness standard to be able to merge and be lowered, with risky speculative activities. And then during this period, Congress prohibited the regulation of risky derivatives. The SEC loosened rules governing the

amount of leverage that investment banks could use, and Federal regulators were defunded and defanged, and they were reluctant to use the authority they had to protect taxpayers and investors.

Some believe that the root cause of the credit cost of this crisis was not only the leverage, but the excessive deregulation. And I would like to ask first, Dr. Wescott, and then others, if you'd like to comment. What do you think were the biggest mistakes or missed opportunities for regulators? And going forward, what do you think we should regulate? Do you think all of this deregulation that I listed was a mistake for protection for our taxpayers and our economy?

Mr. WESCOTT. Regulation is a--as Mr. Wallison said, is an extremely complicated matter, and it is very important that it be handled and that we get the incentives properly lined up here.

There is no question that the regulators did make a decision. The SEC made a decision in 2004, in April of 2004, to relax the leverage standards that the large $5 billion-plus investment banks would be allowed to operate under. And in my opinion, this decision did end up making the situation worse. And so I do--

Mrs. MALONEY. What about Glass-Steagall, Dr. Wescott? That is not complicated. It merely says financial

institutions, bank safety and soundness should not mingle with risky activities. That is not complicated at all. It is very clear. Was that a mistake to roll that back, do you believe? Or I'd ask any other panelist to talk.

Mr. WESCOTT. I don't have a strong opinion on Glass-Steagall. I do think that there were risks involved in the mortgage-lending business that were greater than were appreciated by regulators and obviously by many of the investment banks themselves. The key thing was that they assumed there was going to be plenty of business, and that they could keep getting additional borrowers, and that they would not suffer credit quality loss as we went further and further down the list of applicants for mortgages.

Mrs. MALONEY. Thank you very much. My time is very limited. I'd just like to go down the line, starting with Dr. Zingales.

Do you think repealing Glass-Steagall, allowing banks to mix with risky investment banks that were leveraged in hedge funds, in some cases 1 to 30, 10 to 60, do you think rolling it back was a mistake, yes or no?

Mr. ZINGALES. No. I don't think it was a mistake.

Mrs. MALONEY. Yes or no. Mr. Wescott, you don't think it was a mistake?

Mr. WESCOTT. No at this point.

Mrs. MALONEY. Ms. Minow?

Ms. MINOW. I do think it was a mistake.

Mrs. MALONEY. You do.

Mr. Smith.

Mr. SMITH. It appears to be from this angle. I'm sorry. It appears to be from this angle.

Mrs. MALONEY. Mr. Wallison?

Mr. WALLISON. Not a mistake.

Mrs. MALONEY. Okay. So we're divided on that.

If the Fed and Treasury had not allowed Lehman to fail in default on its obligations, would this have prevented runs on other firms, and especially the money market funds, the run that began on that? Again, down the panel quickly. My time has expired. Quickly now.

Mr. ZINGALES. I think no. The proof is if we look at what happened when Bear Stearns was bailed out, I think that, for example, the price of the credit default swap was--an insurance on default as a measure of how risky borrowers are considered--went up the same amount it went up after the Lehman default. So I don't think that bailing out sort of Lehman would have--would solve the situation.

Mr. WESCOTT. I think that regulators in retrospect would now understand that there was more Lehman paper out there in money market accounts, and they might have made a different decision on that account.

Ms. MINOW. I think it would not have made an enormous

difference.

Mr. SMITH. I think it was one piece of a much bigger puzzle.

Mr. WALLISON. It has no significant difference, I think.

Chairman WAXMAN. Thank you, Mrs. Maloney.

Mr. Davis.

Mr. DAVIS OF VIRGINIA. Thank you.

This concerns the SEC. Both the Chairman and I were instrumental in shepherding through legislation that removed the Civil Service pay ceilings on the SEC employees because they were losing employees like crazy. They lost a third of their senior management because of the pay. We raised that, but we also held hearings on IT and their IT capacity. What were the limitations if SEC had wanted to do something? Were their systems up? Could they have done the appropriate job? Or are there limitations on their IT and personnel that probably limited their abilities? Does anybody have any thoughts on that?

No. Okay.

Ms. Minow, let me just ask you. You rated the corporate boards at Lehman. Did you ever rate the board in salaries at Freddie and Fannie?

Ms. MINOW. I'm sorry. Freddie and Fannie? Yes. We did give a high grade to Fannie Mae after they were--in 2002,

when we began rating after they were cleared by the SEC and OFHEO. We, however, from the beginning gave poor ratings to Freddie.

Mr. DAVIS OF VIRGINIA. We should have seen this coming; don't you agree? I mean, I don't know if any of you are familiar with the Superior Bank. I just was looking at one--Superior Bank, the inspector general report. This was a Chicago bank owned by--the chief owner was Penny Pritzker, who happens to be, as I think many of us know, Senator Obama's finance chairman. But more importantly, when you look at the inspector general's report, it says that the bank became associated with the subprime lending business in '92. Beginning in 1993, Superior embarked on a business strategy marked by rapid and aggressive growth into subprime home mortgages. Federal bank regulators warned them in '93, '94, '95, '97 and 2000 to rein in their risky subprime lending businesses.

According to an independent investigation by the Department of Justice, the bank used improper accounting procedures to cover up their bad debts. Fifteen hundred of the bank customers lost large sums of money. But this was years ago. I mean, didn't--all the warning signs were there that these subprimes were a mess, wasn't there?

Ms. MINOW. Yes, there were. That's why one of my primary concerns is the obstacles to what I would consider

the essential market oversight from institutional investors like the Colorado pension fund, if they could have responded as I think they would like to have. If the corporate community hadn't lobbied for so many restrictions on the ability of shareholders to respond to these indicators, then I think we would not need a lot of new regulation.

Mr. DAVIS OF VIRGINIA. Mr. Wallison.

Mr. WALLISON. Well, I would say that this is a very good example of the faith in regulation that is often misplaced. The regulators had the responsibility for looking at the risks that were being taken by these institutions, and they did not effectively do that. And I think that that is an important lesson for our Congress to understand, because regulation is not a solution to many of these problems, especially when the regulators have a great deal of difficulty understanding what is happening in these institutions.

The Superior Bank case is a perfect example of something that was starting in 2001 and beginning to build at that point with subprime loans. But I'm afraid that if a congressional committee or a regulator--let's put it this way: If a congressional committee had looked over the shoulder of the regulators and said, will you stop that from happening, I think the regulator would have been reluctant to do it. The institutions were making money from this. And

once more, they were afraid of some of the political backlash that would come if they did try to stop this kind of lending.

There is a strong feeling in the United States that many people should have access to housing. And the question is, do you allow the regulators to interfere with a strong housing market, especially involving--

Mr. DAVIS OF VIRGINIA. Lower-income people were getting housing, so nobody wanted to stop that.

Mr. ZINGALES. I think that the problem is not subprime per se, it is a risky lending. But as Mr. Wallison said, it has beneficial effects.

Second, in some situations, a risky--might be profitable. I think that the problem is that the level of securitization this took place was not probably monitored. We have sort of an enormous market that has got completely sort of unregulating type of disclosure. I think we should have more disclosure, because today we don't know who owns what. And out of that, a lot of the problems we observe in the credit market is because banks don't know the losses of other banks. If they don't know the losses, it is because they don't know what is in their portfolio. And if they don't know what is in the portfolio--because if you look at the issuances, you cannot trace back easily what is in that package of loans. We don't know whether they are loans from California, we don't know whether they are from Florida. We

don't know who has these loans. And this lack of transparency is one of the roots of the problem. It is not subprime, It is the lack of transparency.

RPTS JOHNSON

DCMN BURRELL

[11:04 a.m.]

Mr. WESCOTT. Just on the question of whether we should have known or did we know, I will just say that in looking at a full range of economic statistics in the summer of 2005, looking at the value of houses divided by median income and by many other measures, we knew that the housing prices were set for a fall. We were beginning to tell our clients in the autumn of 2005 that housing prices were set for a fall and the housing sector was ready for a decline. We were not alone. Many other economists were also giving similar warnings.

Chairman WAXMAN. Thank you, Mr. Davis. Mr. Cummings.

Mr. CUMMINGS. Thank you very much. Ms. Minow, when I went to church yesterday, it is interesting that almost everybody who came up to me afterwards was very upset. And it seemed like the thing they were most upset about was the compensation for these executives. As part of the committee's investigation the committee asked for copies of the e-mails that Mr. Fuld sent and received over the last 6 months. I want to read to you from an e-mail an exchange that involves Mr. Fuld, his executive committee, and senior executives at Neuberger Berman, a money management subsidiary of Lehman Brothers.

The first e-mail is sent in early June of this year. It is sent from Neuberger Berman executives to Mr. Fuld's executive committee. The e-mail begins, and I quote, as long-term employees and former partners of Neuberger Berman, we feel compelled to express our views on several matters to members of Lehman's executive committee, end of quote. In the e-mail, the Neuberger Berman executives write that Lehman had made, quote, management mistakes, and that, quote, a substantial portion of the problems at Lehman are structural rather than merely cyclical in nature, end of quote.

The e-mail then recommended two actions. And let me read from the e-mail. It says top management should forego bonuses this year. This would serve a dual purpose. Firstly, it would represent a significant expense reduction. Secondly, it would send a strong message to both employees and investors that management is not shirking accountability for recent performance. And then it goes on to say, too, and this is a direct quote, do a partial spinout of NB. A partial spinout could be an attractive source of capital for Lehman at a time when the company needs capital. The officials also suggested that a partial spinout of Neuberger Berman would allow some employees to receive their equity compensation in the new Neuberger Berman shares instead of Lehman shares, which would reassure the Neuberger employees of their funds.

Question: Ms. Minow, what do you think of the recommendations made in this e-mail? And was the recommendations that senior management forego bonuses a sound one?

Ms. MINOW. Yes, it was.

Mr. CUMMINGS. And why is that?

Ms. MINOW. Because in my opinion, management gets paid last. You know, you pay the shareholders, you pay the employees, and then if there is any money left over you take it. But when the company is doing poorly, management should--management compensation should reflect that.

Mr. CUMMINGS. Yeah, because when I talk to the people in my block, they tell me--you said something that was very interesting. You said paying people based on volume as opposed to quality is just the wrong way to go. And the people in my block in Baltimore, if they perform poorly, they get fired.

Ms. MINOW. Yeah.

Mr. CUMMINGS. They certainly don't get a bonus.

Ms. MINOW. That is how it works in my company.

Mr. CUMMINGS. And Mr. Fuld is going to come in here in about an hour, and you know what he is going to say? He is going to say it is everybody's fault but mine, but he was the chief guy, is that right?

Ms. MINOW. He was. He was the captain of the ship.

And you are familiar with the expression "the buck stops here." You know, unfortunately it did stop with him. He took all the bucks.

Mr. CUMMINGS. One of the recipients of that e-mail was George W. Walker. Mr. Walker was Lehman's global head of investment management at the time. And if the name sounds familiar, that is because Mr. Walker also happens to be President Bush's cousin. Within 15 minutes, Mr. Walker writes a follow-up e-mail to the other members of the executive committee. And let me read that to you, because it is extremely interesting. He said sorry, team. I am not sure of what is in the water at 605 Third Avenue today. The compensation issue she raises is hardly worth the EC's--executive committee's that is--time now. I am embarrassed and I apologize. Mr. Fuld also mocked the Neuberger executives. And his response was don't worry. They are only people who think--listen to this--they are only people who think about their own pockets.

Ms. Minow, I see you shaking your head. What do you think of Mr. Fuld's response? I can imagine what you are going to say, because it is clear that he was thinking about his own pockets as he made millions upon millions.

Ms. MINOW. You are exactly right, Congressman. I am horrified by that. I am absolutely horrified. And I am thinking about--I am thinking about what you could possibly

say to him when he arrives here to make him understand his responsibility.

Mr. CUMMINGS. I wonder how he sleeps at night. Mr. Smith, do you have a comment on that? I see you shaking your head, too. You talked about all the employees you represent.

Mr. SMITH. Well, it is of interest to me that nowhere in that conversation, nowhere even in their way of thinking does the shareholder have any role whatsoever. And that is who their duty is to.

Mr. CUMMINGS. Thank you very much. I see my time is up.

Chairman WAXMAN. Thank you, Mr. Cummings.

Mr. Mica.

Mr. MICA. First of all, I think it is very important that our committee investigate how we got into this financial mess. I believe Americans want to know who caused this outrage, how it happened, and who will be held accountable. If it is wrongdoing by AIG or Lehman, in fact I saw one of these signs out here with Code Pink, and they said no bail, jail. And which I agree with. In fact, at the conclusion of these hearings I intend to consult with my colleagues to ask for a special counsel to investigate this matter. The announced hearings, however, today and the ones that we have before us selected by the chairman only cover Lehman, AIG, and several regulators. Unfortunately, I think this is a

clever sequencing of these hearings, which is obviously organized to deflect attention from government-backed financial institutions, and also deflect from Congress any blame, and put it on Wall Street, or blame it on executive compensation.

Any hearing or real oversight that does not start with Fannie Mae, Franklin Raines, who walked away with over a hundred million dollars in executive compensation and bonuses, and also hearing from his accomplices, any hearing will be a sham. This is like investigating the Great Train Robbery and only talking to the dining car stewards. Instead of a balanced panel today, we will take testimony from academics, and no one from Fannie Mae or Freddie Mac. Rather clever.

The fact is that our Nation's current financial crisis began back in 1992, with the concerted effort to expand government-sponsored enterprises Fannie Mae and Freddie Mac to include loans to marginally qualified borrowers and get into a whole host of speculative investments. Last week Speaker Pelosi incorrectly and partisanly attributed the responsibility to the Bush administration's failed economic policies. Chairman Waxman in his opening statement is trying today to direct focus on Wall Street and regulators. Last time I checked, none of those folks had a vote in Congress.

In fact, it was in 1999, and we heard some reference to

this already, I have a copy of the vote here which we will put in the record later, the Congress voted to repeal the Glass-Steagall Act, allowing banks to engage in speculative ventures. And Wall Street followed. In fact, long before Bush took office, the stage was set for the current financial meltdown of the housing and finance industry. In fact, in 1999 the Clinton administration and Fannie Mae Director Raines lowered policy standards and increased subprime loans to new, more dangerous levels.

As quoted in the New York Times that year, Raines said, and I quote from Raines, Fannie Mae has expanded home ownership for millions of families in the '90s by reducing down payment requirements, yet there remain too many borrowers whose credit is just a notch below what our underwriting has required who have been regulated to paying significantly higher mortgages in the so-called subprime market. Wall Street followed.

The New York Times article continued, in moving even tentatively into this new era of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulty during flush economic times, as we saw, but the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan associations, end quote.

In fact, in 2004, Raines and Freddie Mac CEO Richard

Syron told an ABA meeting, and quote, we push products and opportunities to people who have lesser credit. In fact, testimony before the House Financial Services Committee on Capital Markets and Insurance and Government Sponsored Enterprises on October 6, 2004, Raines termed some of these loans riskless. That is his quote.

In fact, Raines by rule change lowered Fannie Mae's cash reserve requirements from 10 to 2.5 percent. In fact, after fraudulently cooking Fannie Mae's books so Raines and Jamie Gorelick and others could boost earnings to rob millions in bonuses, congressional Democrats chose to ignore the findings. During a House Financial Services hearing on September 10th, 2003, the top Democrat at the time, Barney Frank, said the more people in my judgment exaggerate a threat of safety and soundness, the more people conjure up the possibility of serious financial losses to the Treasury, which I do not see. I think we see entities that are fundamentally sound and withstand some of the debt disaster scenarios. Representative Maxine Waters demanded to know why if it ain't broke, why anybody would want to fix Fannie Mae. More incredibly--

Chairman WAXMAN. Thank you, Mr. Mica.

Mr. MICA. --Frank said a few days later, I want to roll the dice a little bit more in this situation.

Chairman WAXMAN. Mr. Mica, you can put the rest of the

statement in the record, but your time has expired.

Mr. MICA. Well, since our side is gagged from either giving a statement or--

Chairman WAXMAN. Mr. Kucinich, it is your turn to ask the questions.

Mr. MICA. --having the opportunity to not ask questions, I won't get to ask my questions.

Chairman WAXMAN. I thought you asked a lot of brilliant questions here. Mr. Kucinich, your turn to ask questions.

Mr. KUCINICH. I thank the gentleman. Mr. Wallison, in your testimony you said voters are justifiably angry about the $700 billion rescue plan just adopted by Congress. Why?

Mr. WALLISON. Because much of the problem that--

Mr. KUCINICH. You want to speak closely to the mike?

Mr. WALLISON. Because much of the problem that this plan is intended to address was caused by a lack of regulation of Fannie Mae and Freddie Mac.

Mr. KUCINICH. Okay. Thank you, sir.

Mr. WALLISON. The bad assets that are now on the books of banks and securities firms all over the world came from a market that they stimulated between 2005 and 2007.

Mr. KUCINICH. Thank you, sir. Thank you for your answer. I am going to go on with the rest of my questions.

I want to say that I agree with you that the American people are angry. I voted against this bailout. And I think

that I have to say that, with all due respect to our Chair, who really was given a mandate to hold hearings after the fact, I am sorry that these hearings are taking place after we voted on the bailout. I mean how much better we would have been, how much better informed we would have been if we had had these hearings before the bailout. And I think that it would have--that takes nothing away from Mr. Chairman, who I have the greatest admiration for, but this is a decision that was made by our congressional leaders. We should have had these hearings first and then taken a vote on a bailout later.

Now I want to get into the questions of why didn't Secretary Paulson save Lehman. We all know about the implications of the collapse. That is what we are here to discuss. But you know, my question is why Secretary Paulson decided to bail out AIG and other companies but not Lehman.

Gretchen Morgenson in the New York Times wrote a column about the decision to rescue AIG. She said that Secretary Paulson, a former CEO of Goldman Sachs, made this decision after consulting with Lloyd Blankfein, the current CEO of Goldman Sachs. She also wrote that Goldman Sachs could have been imperiled by the collapse of AIG because Goldman was AIG's largest trading partner. She said Goldman had a $20 billion exposure to AIG.

Now I would like Professor Zingales, when you hear about

that, you know, a decision was made to let Lehman go down. Goldman Sachs is still standing for sure. Are you concerned, given these facts, that there is an apparent conflict of interest by the Treasury Secretary in permitting a principal of a firm that he was a CEO with to be involved in these discussions about the survival of Lehman?

Mr. ZINGALES. Yes. I am certainly concerned by that. But I have to say that I think that the reason--and I am not saying it wasn't the right decision--I think the reason to go to the AIG bailout is that AIG was a major player in the credit default swap market. And I think that not only Goldman was very heavily involved with that, J.P. Morgan, to the best of our ability, J.P. Morgan has a notional amount of $7 trillion in the credit default swap market. Most of that is hedged. And since they buy and sell insurance at the same time, so if everybody is holding up, there is no risk. But if AIG went under, all of a sudden J.P. Morgan would have found itself probably on edge for a significant fraction of that sort of a $7.1 trillion. Now--

Mr. KUCINICH. Let me ask you this. You throw Lehman Brothers overboard. Does that help what competitive position may remain with respect to Goldman Sachs?

Mr. ZINGALES. I think it is clear that Goldman Sachs benefits from Lehman Brothers going under, yes.

Mr. KUCINICH. I want to ask Ms. Minow to answer the

question that I asked. Is there an apparent conflict of interest here?

Ms. MINOW. Yes, there was.

Mr. KUCINICH. You want to elaborate on that?

Ms. MINOW. You know, that is part of the problem of regulating and deal making and bailing out in the financial sector. You know, we do regressions about the relationships between the various boards of directors. And overwhelmingly, that is the most tightly knit.

Mr. KUCINICH. I want to thank you for that. Because see, what we are confronted with is that bailout legislation gives Secretary Paulson the ability to direct assets over the entire economy, changing forever the idea of a free market and putting him in a direct position where he can benefit the people that he worked with while he was CEO of Goldman Sachs. Does that concern you?

Ms. MINOW. It concerns me greatly, Congressman. And that is why I think it is very important, even though the legislation was already passed, to have these hearings right now, because as you well know, the implementation is going to tell the story here. And even though the legislation is now significantly longer than the original proposal sent over by the administration, there is still a lot of room to make it right or make it wrong. And I think it is going to need a lot of oversight.

Mr. KUCINICH. Thank you very much.

Chairman WAXMAN. Thank you, Mr. Kucinich.

Mr. Turner.

Mr. MICA. Mr. Chairman, I have a unanimous consent request.

Chairman WAXMAN. The gentleman will state his unanimous consent request.

Mr. MICA. I would like to ask unanimous consent to submit for the record the final vote results of roll call 570, which is the Glass-Steagall repeal, which you actually and I voted no on.

I would like unanimous consent to insert in the record H.R. 4071, which Mr. Shays asked me to cosponsor as a cosponsor, to register and regulate the Federal securities laws to include housing-related government-sponsored enterprises in March 20th, 2002.

And I would like unanimous consent to submit into the record the legislation entitled Federal Housing Finance Reform Act of 2005, sponsored by Richard Baker, voted for by myself and others--you weren't with me on that one--that would have resolved this. And also the vote of that I think are important to include in the record.

Chairman WAXMAN. Without objection, that will be the order.

Mr. MICA. Thank you.

[The information follows:]

******** COMMITTEE INSERT ********

Chairman WAXMAN. Mr. Turner?

Mr. TURNER. Thank you, Mr. Chairman. I also voted against the bailout package. And I voted against the bailout package because I believe that it did nothing to prohibit the types of practices we are going to discuss today. It provided no real relief to communities or homeowners who are impacted as a result of these practices. And I believe it does no real understanding of what the requirements will be for administering such a program as we look to the underlying mortgages and the number of housing and house units that is there. And I also don't believe that the value is ultimately going to be there when they take a look at the mortgages and the mortgage-backed securities that they are going to be acquiring.

Dr. Wescott, you said that--you gave us about four or five points as to how this happened. Easy credit, housing prices escalating, securitization of mortgages, houses becoming ATMs. And Ms. Minow, you indicated also excessive CEO compensation. Well, I am from Ohio, and we are one of the leaders, unfortunately, in the area of foreclosures. And I want to tell you a little bit about what our experience is. And I would like to get your thoughts on this.

In 2001, I was serving as mayor for my community. And then city commissioner Dean Lovelace, who was a leader in our community of trying to advocate for people who were victims

of predatory lending, brought to the attention of the city commission and ultimately legislation, which we passed but were not able to enforce, attempting to prohibit predatory lending practices in our community. We then began working with the Miami Valley Fair Housing Center in our community to work directly with people who were impacted. And our community in the past 2 years has had 5,000 foreclosures on an annual basis in a county of about 500,000 people. The State of Ohio I believe is clipping along at about 80,000-plus foreclosures.

And Dr. Wescott, we are not seeing the housing price escalation as the problem. Ohio is not a State that saw wild fluctuations in housing values. In fact, the Miami Valley Fair Housing Center, Tim McCarthy, the director there, tells me that this is what we experienced. Houses that are probably valued between 75, $80,000, people who found the American dream, who got a traditional lending product, were convinced to refinance their house by unscrupulous lenders, predatory lenders, subprime lenders, convinced that the property value was worth a hundred thousand, many times capitalizing the fees, giving the ultimate homeowner a small portion of the cash in the refinancing, the homeowner then facing many times interest rates or payment schedules that they are either not familiar with or not prepared to make; in any event, finding perhaps hard economic times or other

circumstances where they realized that the value of the property is below the actual mortgage value. And ultimately, this property going through foreclosure becomes abandoned in my community. Sitting with a leaking roof, broken windows and many times is now worth $20,000, requiring tens of thousands of dollars for it even to be habitable. We are seeing that scourge around our community. And when I see that, I don't see bad loan choices, I don't see people who just were stretching for the American dream but could not afford it. I see someone having stolen the American dream, where there was a homeowner and a family that were sitting there that were convinced to them what they thought was the most regulated transaction in our country, protected by the Federal Government and rules and regulations, caught in a cycle of refinancing.

But there is someone who knew. The person who originated this loan knows that the value of the property isn't there. They know that this homeowner is not going to be able to make it. And ultimately, as we now know, they take that loan, securitize it, and sell it back likely to the bank that had the first mortgage to begin with that wouldn't have given them a loan like that. Again, I believe these people stole. And I believe it was systematic stealing at such an unbelievable and grand scale that it is going to be very difficult for us to unwind this.

In those circumstances, I would like your thoughts on that very process.

Mr. WESCOTT. Mr. Turner, you described very eloquently a second type of housing problem that we are having in this country. We really have two housing problems. We have the credit-oriented problem that is heavily focused in Florida, California, Las Vegas, and so on. And because this part of the economy, because the housing sector of the economy started weakening, we have actually eaten into real disposable income. We have hurt consumer spending across the country. And what that has done is that has lowered demand for automobiles, for industrial goods, and so on. And that is the core part of the problem in the State of Ohio. It is the same in Michigan. These are regions that have lost hundreds of thousands of industrial jobs, as you well know. And so the fundamental problem in Ohio is the loss of jobs and the fact that many people just don't have the income they did 2 years ago or 4 years ago.

Ms. MINOW. Mr. Turner, I want to repeat that one of the most important factors in creating this problem was pay plans that rewarded the executives on the basis of the number of transactions rather than the quality of transactions. And as I said the last time I spoke to this committee, of course we could never pay Congress what you are worth, but if we were paying you based upon the number of laws rather than the

quality of the laws, I think you see what the result would be. And when we created these pay packages so that they were benefited by just generating as many transactions as possible, chopping them up, sending them all over the place in a form that could no longer be valued accurately, to me that is one of the key sources of this problem.

Mr. TURNER. As we talk many times about falling housing prices, it is going to be interesting when we actually get into these mortgage-backed securities and look at these mortgage transactions, because I think we will find that many of these loans were given on housing prices where the value wasn't there to begin with.

Ms. MINOW. I agree. And I understand that in some cases even the title searches were not completed.

Mr. TURNER. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Turner.

Mr. Tierney.

Mr. TIERNEY. Thank you, Mr. Chairman. I want to thank all of our panel for testifying today. I know we are going to have this hearing and about four other hearings trying to understand the process that got us into this situation. And today we are focusing on Lehman Brothers. Over the weekend we all got a chance to look at Mr. Fuld's proposed testimony for today. And in looking at that, it appears that he blames just about everyone and everything except himself and the

other executives for the downfall of Lehman.

So I wanted to begin by asking this panel for a full diagnosis of just what went on. What were the factors that went into this? Mr. Fuld said it was a litany of destabilizing factors: Rumors, credit agency downgrades, naked short attacks. He says ultimately lack of confidence, and in the end he was overwhelmed. So I want to ask each of you whether or not you agree with that, that Mr. Fuld was a victim of the circumstances or whether or not he and his fellow executives made mistakes, causing the collapse of the company and eventually putting all of us in jeopardy.

Ms. Minow, if I could begin with you. Do you agree with Mr. Fuld's diagnosis?

Ms. MINOW. No. I think it is horrific. I can't believe that he would have the chutzpah to say something like that. I hold him completely responsible. I hold him responsible and his board responsible for the foreseeable consequences of the decisions they made.

Mr. TIERNEY. Professor Zingales, what are your views on that?

Mr. ZINGALES. I think he is definitely responsible for having a too aggressive leverage policy, too much short-term debt that makes the firm sort of at risk of a background that is exactly what happened, and to have not controlled the risk that the firm was taking during this boom period.

All this said, it is also true that we are in exceptional circumstances, and I think that the system is suffering of lack of liquidity. And so it is possible that a lot of banks and firms that in normal times would not be insolvent today find themselves insolvent. The example is suppose that we had no mortgages, what would be the price of your house? And we are in the situation right now. The banks are not lending. And if the banks are not lending, we don't know what the prices of anything is. And at those prices it is very easy that a lot of firms, a lot of banks are insolvent.

Mr. TIERNEY. Thank you. Mr. Smith, you are the only investor on the panel. What are your views?

Mr. SMITH. Well, certainly I hold him responsible, but I think it goes beyond that.

Chairman WAXMAN. Is your mike on?

Mr. SMITH. I am sorry. I certainly hold him responsible. I certainly think they made conscious decisions to take risks that went far beyond the interests of the shareholder. But I also look at the directors, and I look at their responsibility for overseeing management. And I look at the regulatory system that denies investors the opportunity to hold directors accountable. So there are multiple pieces to the puzzle. But I don't believe that he has any safe ground to stand on.

Mr. TIERNEY. Thank you. Professor Zingales and Ms. Minow, if I were to put you or you were to put yourself in Mr. Fuld's position, in 2007 Lehman Brothers paid out nearly $5 billion in bonuses. He himself got a 4 million cash bonus. But at the same time they did that, they spent over $4 billion buying back shares of stock. They paid out $750 million in dividends. Were those actions, almost $10 billion of capital dissipated in that sense, were those wise decision under the circumstances?

Ms. MINOW. No. I don't think they were. And I will say that I am a real radical on the subject of CEO stock sales. He was also selling a lot of his stock at that time. And I don't believe that CEOs should be allowed to sell stock while they are still with the company.

Mr. TIERNEY. Dr. Zingales.

Mr. ZINGALES. No, it was not a wise decision. He should have increased the equity base, not reduce it at that moment.

Mr. TIERNEY. I noticed that in June of 2008 the Lehman Brothers had a $2.8 billion loss on their books, and that sent everything--stunning the markets, sent everything spinning. If they had that $10 billion that had gone to bonuses and to dividends and buybacks, it certainly seems that they might have avoided that situation as well.

Do you know, Dr. Zingales, what the amount of money that

Mr. Fuld was seeking from the Korean Development Bank toward the end?

Mr. ZINGALES. No, I don't know the exact amount.

Mr. TIERNEY. Do you, Ms. Minow?

Ms. MINOW. No, I do not.

Mr. TIERNEY. I believe it was probably $6 billion or less. And my point was again, if you take that $10 billion off the books, you lost that opportunity to do something substantial in terms of saving that company and saving our economy on that. But we can explore that further with Mr. Fuld.

But I do want to just cover an e-mail exchange between Mr. Fuld and one of his top executives, David Goldfarb, that was dated May 26th of 2008. In that, Mr. Goldfarb reports that a possible deal with the Korean Development Bank would provide several billion dollars worth of new capital to Lehman. Mr. Goldfarb describes what he would like to do with the money, and he writes as follows. It feels like this could become real. If we did raise $5 billion, I like the idea of aggressively going into the market and spending two of the five and buying back lots of stock and hurting Einhorn bad. Now, in the e-mail Mr. Goldfarb was referring apparently to David Einhorn, who at the time was publicly critical of Lehman and was shorting its stock. Mr. Fuld wrote in a short response, I agree with all of it.

So here is how I read this e-mail. Lehman was dangerously low on capital, and possibly found an investor willing to give them billions of dollars. And what they wanted to do with it, however, was buy back stock and punish a short seller. Mr. Smith, what are your views about that e-mail exchange, being an investor?

Mr. SMITH. Well, horrified. When you know that you are low on cash, when you know that you have exposed your company to what I have heard as ranging from 35 to 70 times leverage, and you are giving away your cash with a motive of punishing someone rather than benefiting your shareholders, that is the ultimate breach.

Mr. TIERNEY. Thank you.

Chairman WAXMAN. Thank you, Mr. Tierney.

Ms. Watson?

Ms. WATSON. I really think this is the most important hearing we have had in this particular Congress. I thank the experts for coming out this morning. I just returned from California, the largest State in the Union, 38 million people. It was a turnaround for me. And I tell you, they followed me out of church, they followed me at several dinners, political dinners. Everyone was outraged over the $850 billion of their moneys to bail out people who have shown nothing but corporate greed. And I am hoping that as a result of the six hearings we are going to have that we can

come out with a policy that will really curtail this greed out of control.

Now, looking at Lehman Brothers and trying to get to the bottom of what caused this economic crisis that we are in, the makeup of the board may provide some insight with what went wrong. Seven of the 10 board members were retired. Many of them lacked Wall Street experience. And the Lehman board members included the former head of Telemundo, who was a retired Navy Admiral, and a theater producer.

And so I am directing this to Ms. Minow. You are an expert on corporate governance. Do you have concerns about the effectiveness of the Lehman board? And let me just mention one board member, Mr. Roger Berlind, the theater producer. He has been on the board for 20 years, and sits on the audit and the finance and risk committees. What are your concerns about having a board full of people like Mr. Berlind?

Ms. MINOW. Thank you, Ms. Watson. As I said in my testimony, we rank boards based on the decisions they make, and not on their resumes. And I will say in fairness to Mr. Berlind that yes, he is a theatrical producer, he does have a background in finance, and was the co-founder of a Wall Street firm at one time. However, I think it is clear that the members of this board had no clue about the kinds of securities and other issues, the derivative securities and

the credit default swaps that we have heard about today. And the fact that the risk committee met only twice 2 years in a row I think tells you everything you need to know.

So I rank this board very, very poorly. They currently get an F from us.

Ms. WATSON. I see one of the biggest problems in corporate governance is how entrenched the board can become. And under current law, there is no effective way for shareholders to challenge an incompetent or negligent board. And in the bailout bill, Chairman Barney Frank tried to address the problem of these entrenched boards. And he said that shareholders should be able to propose their own candidates for the board. The theory behind this reform is that if the board gets too close to management, as the Lehman board did, the shareholders can vote in a new board with more independence and oversight. Unfortunately, Secretary Paulson insisted that this corporate governance reform be dropped from the bill.

So I would like to ask you first, Ms. Minow, was this an important reform? And then Mr. Smith, do you have a view on this? And Mr. Zingales, what you think. In that order, please.

Ms. MINOW. This is a crucial reform. Mr. Smith mentioned it in his testimony. I have got it in my written remarks. At this point, you know, I always love bringing

this up when I am speaking to the committee because one thing that you all understand very, very well here, very intimately is the concept of an election. And yet we call it an election for a corporate board, and only one person runs, no one runs against them, and management counts the votes. It is a pretty good system. We have got to have some way--this is exactly what I am talking about when I say we need to remove the impediments to oversight from investors so that we can remove directors. There are currently more than 20 directors serving on boards today who did not receive a majority vote from their shareholders. Shareholders did everything they could to say we don't want you and they are still serving. So we definitely need to improve that system.

Thank you.

Mr. SMITH. Yes, that certainly is one of the biggest reforms I would like to see. It is the only place I have ever seen where--

Chairman WAXMAN. Is your mike on?

Mr. SMITH. Pardon me?

Chairman WAXMAN. Is your mike on?

Mr. SMITH. Yes, it is. Who are our representatives, the shareholders' representative is not picked by the shareholders and the shareholders have nothing to say about who they are, and they are not accountable to the shareholders. Their presence in the board room is dependent

upon management and whether or not management puts them on the slate. That is not a good connection for the shareholders to have their voice heard in a board room, and it has failed us.

Mr. ZINGALES. I completely agree with you. In fact, there are very few things that the United States can learn from Italy, but Italy has a law that allows representatives of institutional investors to be elected on board. And I happen to be one of those. I sit on the board of one of the largest companies in Italy, Telecom Italia, as representative of institutional investors. And I sit on their compensation committee, and I can actually argue about their compensation. And I can tell you that last year I wasn't particularly polite in some of the conversation. And if I was appointed by management, I would not have been renewed. But I was renewed because I am appointed by institutional investors and I represent shareholders on that board.

So I think that would be a very important reform that we could pass.

Chairman WAXMAN. Thank you, Ms. Watson.

Ms. WATSON. Thank you so much.

Chairman WAXMAN. Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chairman. Just a couple of thoughts. Virtually every recession or severe economic downturn originates in excesses in the financial economy.

And then they go on to ruin the real economy. I think the recent financial crisis is consistent with that. And I find in my review of the facts four basic abuses: A lack of transparency, excessive leveraging, conflicts of interest, and most egregious, the probability of dishonesty and deceit.

Lehman Brothers didn't just collapse on September 15th. Its financial situation has been getting increasingly dire with each passing quarter. But Lehman's executives kept telling shareholders and public investors that its finances were in great shape. In September 2007, Lehman's chief financial officer told investors, quote, our liquidity position is stronger than ever. In December 2007, CEO Richard Fuld said, quote, our global franchise and brand have never been stronger. In March 2008, Lehman fired its chief executive officer and hired a new one. The new chief financial officer told investors, quote, I think we feel better about our liquidity than we ever have. In June 2008, CEO Richard Fuld told shareholders, quote, our capital and liquidity positions have never been stronger. And on September 10th, 5 days before Lehman filed for bankruptcy protection, Lehman made upbeat comments to investors and research analysts.

Mr. Smith, you represent a state pension fund. Your fund manages retirement assets of public employees in the State of Colorado. What do you think about these statements

by Mr. Fuld and others at Lehman? Were they giving you an honest assessment of what was going on inside the company?

Mr. SMITH. Well, clearly, they were not giving us an honest assessment of it. And unfortunately, neither were the books, neither were the auditors. There was no piece of the puzzle that allowed us--we are big boys and girls. We invest billions of dollars. We understand how to invest. We understand how to do due diligence. But you have to have the tools to do that. And you have to have people who are going to be honest enough to tell you the facts, or at least have you have the ability to go mine the facts yourself. And in today's situation, and for many years now we have been unable, we have been impaired in our ability to do that.

Mr. HIGGINS. Professor Zingales, what is your view? Could Mr. Fuld have been truthful when he said in June of 2008 that our capital and liquidity positions have never been stronger?

Mr. ZINGALES. It is hard to imagine that it was never stronger than that. I think that it is clear that was a moment of crisis, and it is clear that he didn't have a good understanding of what the situation was. If it is true, as was said, that he was indicating that they would buy back stocks in order to punish the analysts, I think--I am sorry, the short sellers, this is a typical situation of overconfidence by a CEO that doesn't see the problems as they

should be. And he thinks that the responsibility is all on the market that gets it wrong. It is all on the short sellers, the short sellers of stocks, and they don't see the problem coming.

Mr. HIGGINS. Mr. Fuld had a vested interest in painting a rosy picture at Lehman. If he had disclosed its precarious situation it could have put more pressure on the company. That is why I believe the disclosure rules are so important. Investors shouldn't have to rely on the rosy assessment of corporate executives. They should be able to verify those statements in reviewing public filings of the company. Mr. Smith or Dr. Wescott, what are your views about disclosure rules?

Mr. SMITH. Well, I was just mentioning I should have hit transparency a little harder in my answer. I appreciate the loop back, because that is what we believe was lacking with the off balance sheet opportunities, with the loosened accounting rules, with the obfuscation of the leverage that they were actually imposing on the assets of the organization that were in large part undetectable by an investor. Didn't have much of a fair shot at assessing our risk when we got into that.

Mr. WESCOTT. A quick comment. Basically, there are two ways you can go if you are going to regulate an industry. You can have very, very tight regulation. At the limit, you

can imagine a regulator basically working full-time in the institution looking at every number every day. And that is one way you could go. The other way is to back off and to allow--to have less day to day, minute to minute regulation. If you are going to go that way, though, you have to--the key building block is disclosure and transparency. And that is--if you don't have this very minute level of regulation, you have to have disclosure and transparency.

Chairman WAXMAN. Thank you, Mr. Higgins.

Mr. HIGGINS. Thank you, Mr. Chair.

Chairman WAXMAN. Ms. McCollum.

Ms. MCCOLLUM. Thank you, Mr. Chairman. I want to go back to September 10th, because that is 5 days before the bankruptcy filing. It is my understanding that the chief financial officer held a conference call for investors. And that was reported in the Wall Street Journal. And in fact, some of the bankers even advised them not to hold this call because there were going to be too many open questions. And I would like to know from the panel, to your understanding is this accurate?

Ms. MINOW. I don't have any information about that, sorry.

Ms. MCCOLLUM. My understanding is at the time that they were making this call they were trying to raise capital through new investors or by off selling assets. Dr. Wescott,

Dr. Zingales, any comment on that?

Mr. WESCOTT. Unfortunately, I don't know the details of what was going on.

Mr. ZINGALES. Neither do I.

Ms. MCCOLLUM. One of the concerns that I had, Dr. Zingales, from your testimony, you talked about how there were three issues kind of involved to Lehman's collapse. One of them that we haven't spoken about very much was the whole idea of the credit market swap that was involved in here. So irrespective of whether or not they were making good investments, and they definitely were not in the home mortgage securities, could you elaborate on Lehman Brothers' role in the credit swap?

Mr. ZINGALES. Actually, the role of Lehman in the credit default swap market is relatively limited. There is a table in my long testimony, I think it is table 5, that reports the best numbers we have regarding sort of the amount of credit default swaps in place. And Lehman is 25th in the list. So they definitely had some sort of play in the market, but not a huge play in that market.

Ms. MCCOLLUM. But when there is lack of confidence in the market, to what degree did these--I mean they were out there hustling for cash, looking for something. They knew that they had problems with the loans that they had accrued. The fact that they got even involved in doing this credit

swap, does that bring any--from my research, that does not bring any stability to a company. In fact, it adds to destability.

Mr. ZINGALES. It depends what position they take, because if they were hedging their risk by taking insurance along the way, this should in principal have reduced their risk. Of course if they were selling insurance, that would have been crazy, but I don't think at that time people would have bought the insurance because they were sort of rumored to be in difficulty. So you don't want to buy insurance from an insurance company that you are not sure is going to be around to pay when your house is in trouble, for example.

Ms. MCCOLLUM. Could I ask each one of the panelists, there was great discussion about privatizing Social Security. And as we have heard from the gentleman from Colorado, a lot of pensions had their security assets in fact involved in these types of products. Could you tell me what, in your opinion, privatizing Social Security would have meant for Americans today had that plan gone through?

Mr. SMITH. Well, the beauty in our view as a pension system, and particularly a hybrid defined benefit pension system is that we are able to pool at least some of these market risks for our members. The members in our system who were within a year or so of retiring and faced this crisis probably still have the ability to retire, because we have a

long-term ability to provide those benefits. If they were on their own and they were in individual accounts that were under their control and their responsibility, they would be left with only that, and that would be inadequate to provide for them in these times. And this cycle would have caused them to go back to work for years into the future. So it would be devastating to have individuals--in my view, to have individuals and individual accounts out there trying to survive in what is a market that lacks transparency.

Mr. WESCOTT. Just there are many different proposals of how to do a privatization of Social Security. There is carve out, there is add on, and so on. So it is difficult to know exactly which type of plan we would be talking about. The key for insuring safe retirements for Americans is diversification, a blend of income, some coming from Social Security, some coming from company plans, some coming from private 401(k) plans or individual plans. What we really want is to have a blend of money so that you have multiple sources, each of them subject to different risks.

Chairman WAXMAN. Thank you very much. Did anyone else wish to respond to the question? Thank you, Ms. McCollum. Mr. Van Hollen?

Mr. VAN HOLLEN. Thank you, Mr. Chairman. I thank all of the witnesses for being here today. I just want to pick up on a point that Ms. Minow raised in her testimony

regarding the link between executive compensation and overall performance. We are looking at Lehman Brothers as a case study today. We have AIG tomorrow. And then we will go on to some of the more systemic issues. But I think what we are seeing today, just looking at Lehman Brothers, is a good case study of the fact that you don't have this alignment between pay and performance. In fact, as my colleague Mr. Cummings was saying, unlike the rest of America, where pay for performance means you get rewarded when you do well, but you actually get--there are disincentives, you get cut in pay when you do poorly, the fact of the matter is on Wall Street you do well when they do well, and you do well when they are doing poorly. And that clearly is a mismatch. And I think it is important to look at this to make the recommendations you have talked about in terms of what we can do legislatively to better align stockholders' interests with those of the executives who are making decisions. And one problem I think is the fact that people are urged to take big risks to maximize short-term pay and bonuses at the expense of longer term well-being of the company and the stockholders. And I think one of the reasons that happens is because people think that when they make bad decisions they are going to still get bailed out.

I want to talk to you briefly about a memo that was written at Lehman Brothers by the compensation committee on

September 11th. That is 4 days before Lehman Brothers declared bankruptcy. And it is a recommendation from Lehman Brothers to the compensation committee of the board. It discusses a number of the separation payments, including one of them to Andy Morton. Mr. Morton was the head of Lehman's global head of fixed income. He was the person who was responsible for the leveraged investments that were a good part of what drove Lehman into bankruptcy. Another was Mr. Benoit Savoret, a member of Lehman's executive committee. It says that they both had been involuntarily terminated. They have been fired. And so you would think, you know, when you get fired, bad performance, no pay. But it goes on to recommend giving them cash separation payments combined of $20 million, 16.2 million for Mr. Savoret, and 2 million for Mr. Morton. And it calls--in the memo they describe these as special payments. And they come up with a rationale for providing these kind of last minute bailouts to these guys. Is this part of the mentality of sort of an insatiable, you know, insatiable sense of entitlement on Wall Street that suggests that even when you do badly someone is going to be there to bail you out?

Ms. MINOW. I couldn't possibly have put it as well as you did, Congressman. That was perfect. I had to laugh, though, when you said this was a good case study. I wish it was the only case study. It is just replicated over and over

and over and over again. And you are right, they are so completely out of touch, that on the upside they always say I am responsible, it is a market test, I am Michael Jordan, I am A-Rod, I deserve this. But on the downside, it is never their fault. And if we don't have better shareholder oversight, if we don't have better market response to them, then they are never going to get the message.

Mr. VAN HOLLEN. Let me just read to you their description of why these are apparently justified in their view. They say these executives are, quote, very experienced senior executives with valuable business skills and experience that the corporation may wish to leverage. Again, these are the guys who helped obviously contribute to the downfall. It also says, and I quote, the corporation would face significant impacts if the terminating executives should fail to provide appropriate transition assistance, solicit clients, or engage in other behavior that may be detrimental to the corporation.

Now that you have heard the rationale, does that pass the common sense smell test?

Ms. MINOW. Not at all. But this goes back to a point that I made earlier where I said I take a very hard line. I don't believe they should be allowed to sell their stock until after they leave their company. And if that doesn't motivate them adequately, then they are not paying attention.

But I think it is hilarious that they use the term "leverage." Because one thing we have learned about this company is they didn't understand leverage at all.

Mr. VAN HOLLEN. Mr. Smith, as somebody who entrusts these individuals with lots of decisions, is that the kind of pay for performance that you would want to see?

Mr. SMITH. Certainly not, and certainly highlights our desire to have say on pay as a shareholder, to be able to be in the board room or have a representative in the board room that actually is looking at those payments and saying how is this going to bring value to my shareholders? And I would contend that there is categorically no way those payments could bring value to the shareholders.

Mr. VAN HOLLEN. Thank you. Thank you, Mr. Chairman.

Chairman WAXMAN. Thank you, Mr. Van Hollen.

Mr. Cooper?

Mr. COOPER. Thank you, Mr. Chairman. I would like to explore the role of excessive leverage in the downfall of Lehman Brothers. Professor Zingales starts his whole testimony by saying the downfall of Lehman Brothers is the result of its very aggressive leveraging policy. Could you help the public understand how leverage magnifies gains or losses?

Mr. ZINGALES. Sure. Let me make sure that you all understand what we are talking about. When you buy a house

and you put a 10 percent down, you are basically buying something that is worth 10 times what you put down. So your ratio is 10 to 1. That is the leverage. What Lehman was doing was 30 to 1. So it was much more than what most people do in buying their house. And this exposes you enormously to fluctuations in the value of the underlying assets.

As I said in my testimony, if you have a drop of only 3.3 percent in the value of your assets, your entire value of the equity is wiped out, and so you are insolvent. And this system, as was mentioned by the chairman, is very rewarding on the upside, so that when things go well you have very high sort of earnings, you have very high return on capital, and this allows you to pay very large bonuses. On the downside, this is very dramatic. And so especially given sort of the situation in which we were, the risk on their assets and the risk of a downturn in the housing market, it was not sort of not foreseeable, I think their leverage policies should be much more cautious. But also it is not only the leverage, it is also how much of that leverage is short term. Because when you have a problem, the short term lenders can leave you and create a situation of insolvency, which is exactly where Lehman was. And before the beginning of the crisis, 50 percent of that leverage was made of short-term debt, which is very profitable in the short term because short-term debt, especially in the current environment, is much cheaper than

long-term debt but exposes more to a risk of a run, and that is exactly what happened.

Mr. COOPER. So Lehman was levered I think at the start of Dick Fuld's tenure at 27 times, and then it went to 37 times. And now that there are no major investment banks left on Wall Street, even Goldman Sachs and Morgan as I understand are down to about 10 times leverage. So it has been a substantial contraction of the leverage ratios.

Dr. Wallison, could you tell us what you think an appropriate leverage ratio would be for investment banks, assuming we have major investment banks return to America one day?

Mr. WALLISON. I don't think, Congressman, that you can give a number. It depends very much on the risks that they are encountering in the market at a given time. It is obvious, it should have been obvious to the management of Lehman and any other management that when things can't continue, as Herb Stein once said, they will stop. And as a result, a provision should have been made for a downturn. But there isn't a number that is the right number under any circumstances.

Mr. COOPER. But it is sounding today, since no firm, major firm left in the country is leveraged at 30 to 40 to 1, that that must be too much, right? Another point about leverage is the fulcrum on which the lever rests, the

capital, the equity that Lehman thought it had on its balance sheet. And Professor Zingales, didn't you say in your testimony on the day they went bankrupt it supposedly had $26 billion on its balance sheet?

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[12:02 p.m.]

Mr. ZINGALES. Yes, $26 billion in book value of equity. The problem is the market value of the equity depends crucially on the value of its assets; and the uncertainty that was created in the value of the assets in part by lack of transparency, in part by the liquidity crisis made it impossible to know exactly what it was. And when the market becomes nervous, that is the moment they pull out their money. That is the reason why adding a lot of short-term debt is not wise, because in that situation you can have literally a bank run, and that is what happened.

Mr. COOPER. So a contraction in credit because of excessive leverage crushed $26 billion in capital, which we question the value of anyway, because, apparently, mark-to-market rules didn't necessarily apply quickly enough in this case. And I think that leaves a lot of folks back home wondering whether this is Wall Street or a casino.

Because, as you conclude your testimony, Professor Zingales, you say Lehman did not find itself in this situation by accident. It was the unlucky draw of a consciously made gamble. That doesn't sound like an investment. That sounds like gambling.

Mr. ZINGALES. I think, as I said in my testimony, they

were too aggressive in their leverage; and that is the reason why I think they should not have been bought out. My major concern is that if we bail out everybody who took those gambles, we are going to create incentives to have more gambles down the line. And I think that there is a strategy on Wall Street to sort of take a lot of gambles on the outside and then walk away when things don't work out. And if you don't get punished when things don't work out, everybody will play that gamble over and over again. So I think we have to be very careful on what we do now, because I think that what we are doing now will define incentives for a generation to come.

Chairman WAXMAN. Will the gentleman yield? Just for me to point out that the regulation of commercial banks is that the leverage is no more than four to one. So I guess every--all the banks are now commercial banks. But there is a spelling out of it--of a leverage number.

The next person to question would be Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

Of course, we have all alluded to the fact that there is a lot of people who are angry out here in the country. I expect that when we are done with these five hearings they are going to be a lot angrier, because they had deep suspicion about this culture of greed and recklessness on Wall Street. Now they are going to have plenty of proof

positive of it once we are done with these hearings.

I don't think there is any surprise to be found in the huge either golden parachute packages or compensation or salaries that these folks got used to thinking they should have. When you look at the amount of money they are playing with--and I use the phrase "play with" rather than "manage" because that's where it seems things seemed to get. So you put it in that context, and they lose all perspective. They are not living really in the same world that everybody else is living when they are dealing with these kinds of dollars under these sorts of conditions.

And I have got to go back to what Congressman Higgins was asking about before. Because if you're Richard Fuld, I mean, how do you lose all commonsense? I'm looking at these statements that he made. Late in the game, like right before this thing falls apart, our global franchise and brand name--our brand have never been stronger. In June of 2008, still in this year, our capital liquidity positions have never been stronger. This is a no-win statement from him. Because either he has lost all perspective and is completely clueless in a statement like that or he is quite savvy but he is deceiving people affirmatively.

You could pull anybody out of any coffeehouse anywhere in this country who are small businessmen and you could lay out for them the basic metrics of what was happening to this

company at that moment in time and they would say, are you kidding me? Are you kidding me that this was a strong position? I mean, anyone would recognize that.

So here is my question. How does this happen? Talk to me a little bit about the culture, the external culture--in other words, if you're Richard Fuld, you've got your company's culture that you're dealing with, and then you have got the larger culture. So what happens that makes him lose such perspective? Or, if you want to look at it another way, think he can get away with this kind of public pronouncement. Is it the parties you're going to? Is it the fact that the analyst division of your own company suddenly evaporates and stops doing its job? I mean, what is happening to get you to this point? Anybody. Yes.

Mr. WESCOTT. Let me take the first cut at this.

Think of the--you're having a monthly management meeting of your management team, you have the heads of your profit units there, and you're giving--if you're the CEO, you're giving them their profit targets, let's say, for the quarter. This trading desk, you're expected to have $100 million of profit; that trading desk, $50 million; and so on. In the room, you have the corporate risk officer; and these companies--all of the investment banks have risk officers. Their job is to be looking at the financial developments, at the trends of housing prices, subprime loans and so on. And

when you're sitting around the table, the profit managers are explaining what their prospects are for hitting that profit target.

Presumably, the risk officers there are saying, we are getting kind of nervous here, because we're now pushing the envelope in this area. I think maybe we need to cut back the profit target for that--let's say, that trading activity or whatever activity, because it is starting to feel risky.

Ultimately, that is what the CEO is being paid for. He is being paid for that judgment, hearing the debate that is going on. And probably in many of these cases, the risk officers were not speaking up quite loudly enough.

Ms. MINOW. Mr. Sarbanes, I always say when I look at boards of directors, more than being a financial analyst, more than being a lawyer, I'm an anthropologist. Because I think you have to look at kind of the anthropology of the board room. And when you have got a CEO who picks his board to make sure that it is a bunch of retirees who barely know what a derivative is and have a risk committee that meets only twice in a year, you have kind of an emperor's new clothes problem. Nobody wants to tell him the truth, and he intentionally surrounds himself with people who are complicit.

If you look at the part of my testimony where I talk about the related party transactions, these are people who